# Guns N' Money: Europe's reaction to the new geopolitical reality

Reduced US military support means that Europe must step up defence spending. But the question is, who will pay for it? Countries will be allowed to run higher deficits to finance the extra spending but this approach risks amplifying fiscal pressures

The start of negotiations between the US and Russia over Ukraine without involving Ukraine and Europe should have been the final wake-up call for Europe to up its game on defence security. This is a trend that started under Donald Trump's first presidency, persisted with the Russian invasion of Ukraine and now appears to be continuing in Trump's second presidency with minimal US military support in Europe.

The end of the so-called peace dividend – using cuts in defence spending as a vehicle to keep fiscal budgets in shape and leaning too long on the US – is now forcing Europe to increase defence spending and invest in its own domestic military industry. There are many economic aspects to

this broad topic but we will only focus on two for now: the economic dimension and funding. Or Guns N' Money.

## The economics of Europe's defence spending

With the fall of the Berlin Wall and the Iron Curtain, Europe entered a prolonged period of disarmament. This era saw the end of compulsory military service, a reduction in defence, and a subsequent decline in spending on military equipment. According to Bruegel estimates, government spending on military equipment in the European Union amounted to an average of some 0.3% of GDP between 2008 and 2020. The share of total defence spending in the EU dropped from 2.3% of GDP in 1990 to 1.3% of GDP in 2014. Of the larger EU economies, Germany, in particular, lagged behind. To some extent, it looks as if (reduced) defence spending was another important lever to achieve a balanced budget goal. Returning to the EU, total defence spending increased from 1.3% in 2017 to 2% of GDP in 2024. However, the EU number masks that seven EU NATO member countries still do not meet the NATO target of 2% of GDP.

NATO has already indicated that maintaining the alliance’s targeted military capabilities could require increasing spending targets from the current 2% of GDP to around 3.6%. With last week’s events, further increases can no longer be excluded.

Spending some 4% of GDP should have a significant impact on the total economy. Up to now, the European military industry has remained relatively small and overshadowed by the broader economy. And since the Russian invasion of Ukraine, roughly 80% of the EU’s defence procurement has gone to non-EU firms. One reason for this is the limited production capacity. The European market for military equipment is also fragmented, lacking unified European standards and procurements, relying instead on national ones. Europe currently lacks economies of scale to cater to the sharp increase in demand.

We will explore the potential benefits that the defence industry could offer to the European economy at a later stage. Currently, the industry has a turnover of around €70bn and employs some 500,000 people. It’s clear that investing about 4% of GDP in the domestic industry could have a substantial impact. Last year, a cartoon circulated showing the German automotive industry’s future as producing electric tanks. Maybe that's a bit exaggerated but it's no longer a complete fiction.

## How to pay for it

The heat is on and discussions in Europe are gaining momentum. The focus has shifted from 'if' to 'how' to increase defence spending. Various figures are still being debated. While the countries bordering Russia have called for €100bn of immediate spending, European Commission President Ursula von der Leyen has mentioned €500bn over the next decade. NATO has indicated an increase from 2% of GDP to around 3.6% of GDP. To be clear, an increase in the EU’s annual defence spending from 2% of GDP to 4% of GDP would equal some €340bn, per year.

As so often in Europe, the question arises of how to pay for it. Taking the 2024 spending levels as a starting point, the countries that have the most catching up to do are Southern European countries Spain, Italy and Portugal, as well as Belgium. The need for all European countries to go above the 2% of GDP level will amplify fiscal pressures here. Financing higher defence expenditures with austerity measures elsewhere in national budgets looks like a dangerous social experiment. Financing higher defence expenditures with higher deficits could become a new experiment for

financial solidarity and stability in Europe.

Remember that during the pandemic, the fear that different fiscal capacities across member states could trigger a new sovereign debt crisis eventually led to NextGenEU, with the Recovery and Resilience Fund as its centrepiece.

As Europe is likely to move towards closer EU procurement and more harmonised standards in the defence industry, steps towards pan-European funding could be the next logical step. This raises the question of what a common funding approach might entail. Current proposals revisit long-standing pan-European funding models.

- There have already been efforts to expand the **European Investment Bank's (EIB)** mandate to provide investment funding in the defence sector, or even issue "defence bonds". The EIB though is mindful of maintaining its credit quality and reputation and will likely be reluctant to expand into the sector if this push into military financing does not involve a wider acceptance from commercial lenders.
- Using the existing **European Stability Mechanism (ESM)** is another avenue that has seen some consideration. Some €427bn out of the €500bn in lending capacity remains. However, it would very likely require changing the treaty as the conditions of when it is deployed are narrowly defined around providing financial assistance when countries are threatened by severe financing problems.
- That leaves the option of creating an entirely **new issuer**, like a European Defence Fund, but depending on the setup, it could require a new treaty and of course, new paid-in capital. Considering the large financing volumes, the question remains to what degree the subscribed capital could be leveraged while also maintaining a funding cost advantage over individual countries' debt issuance. Much would depend on the eventual guarantee structure (e.g. jointly versus severally guaranteed debt). A new issuer would not be limited to providing financing to just EU or eurozone members but could include e.g. the UK as well.
- The **EU as an issuer** has proven its ability to quickly ramp up funding. In the wake of the pandemic, it first launched the €100bn SURE programme and the NextGenEU with a capacity of up to €800bn. But it would again be limited to providing financing to EU member countries. And it is likely that governments will have to agree on additional ways to bolster the EU's own resources to maintain its strong credit in the long run.

## First national, then European?

The issue of defence spending is complicated by the unequal benefits to countries from the defence industry and employment, and by the fact that a common approach faces another issue: coordinated action cannot be achieved through finances alone. However, at least for now, financial markets seem to be more convinced of an imminent common European approach, reflected in a tightening of eurozone sovereign spreads.

We think that a 'first nation, then European' approach is the most likely way forward. The European Commission's announcement to once again trigger the escape clause of the Stability and Growth Pact suggests that indeed Europe's first line of defence will be to allow European countries to run higher deficits to finance additional defence spending. This would probably also mask differing views and differing levels of complacency. However, such an approach runs the risk of new sovereign debt tensions with potentially widening bond yield spreads. Consequently, and we know the script, it would then be the European Central Bank's job to step in with new asset purchases or targeted liquidity for banks, followed by an eventual European funding solution.

Making such a path clear from the onset would help to stifle market turmoil.

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